The Economic and Geo-Political Implications of China-Centric Globalization

Thomas I. Palley, New America Foundation

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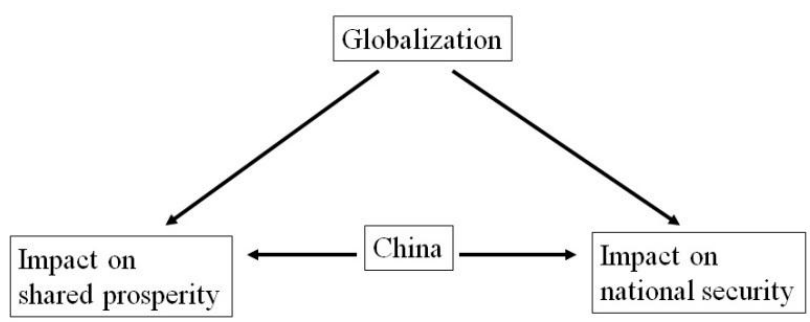
Introduction

The last 30 years have witnessed the era of globalization which has been marked by the creation of an integrated global economy. Globalization has been the product of both policy and market forces, and U.S. policymakers have persistently been in the vanguard. However, what began as a project of globalization has been transformed with little explicit public discussion into a project of China-centric globalization.

Figure 1. The nexus between globalization, China and U.S. national security and shared economic prosperity.



China-centric globalization is characterized by three features: (1) the emergence of China as the global center of manufacturing, with China playing the role of factory for the world; (2) the creation of a new dollar zone shared by the U.S. and China and enforced by China's adoption of an exchange rate pegged to the dollar; (3) the development of China as the fulcrum of U.S. engagement with the global economy, with the U.S. having a massive trade deficit with China and transferring significant chunks of manufacturing capacity to China.

Globalization has always been controversial but China-centric globalization has made it even more so. Globalization poses challenges for the character of America's economy, for the goal of shared prosperity, and for U.S. national security. China-centric globalization amplifies these concerns by aggravating adverse economic tendencies within the globalization process, and by raising additional national security concerns about dependence on China, with whom the U.S. still has an uncertain geo-political relationship.

Looking into the future, the current path of China-centric globalization poses a threat to both U.S. economic recovery and global growth and development. It has not only hindered American attempts to escape from the post-bubble recession that began in December 2007 but it has also threatened to block future attempts to recalibrate and improve the globalization process. If anything, U.S. policy has failed to come to grips with the problems associated with China-centric globalization. Especially troubling is the U.S. Treasury's policy toward China's exchange rate. The Treasury's past policy can be accused of dereliction of duty in its failure to protect the U.S. manufacturing sector. Its current policy of encouraging China to introduce a flexible yuan exchange rate with free capital mobility promises to compound that damage.

It is important to remember that China-centric globalization has been largely the product of U.S. policymakers and U.S. corporations. It therefore should be subject to review. As it is now, China-centric globalization has set in motion a momentous process that is causing changes of historical proportions. This process has developed rapidly with little public consideration of its implications. It was put in place in the late 1990s by a triumphant corporate sector, at a time when the public was caught up in the euphoria of a long-running cycle of asset bubbles that created illusory prosperity. Change of this proportion would be dangerous even if the U.S. and China were close allies, which they are not. At the end of the 19th century, a similar seismic shift of economic power between Great Britain and Germany, whose monarchs shared a common lineage, contributed to the tragedy of World War I. That history speaks to the dangers of such developments and should be a caution to U.S. policymakers. The troubling developments already in place and in prospect should be an alarm. Yet, U.S. policymakers do not seem to have fully grasped the dangers inherent in China-centric globalization.

The rise of China-centric globalization

China-centric globalization constitutes an evolution of corporate globalization, which itself evolved out of the post-World War II free trade era. Table 1 shows the era of free trade (data only for 1960 – 1980). This era saw a significant increase in exports and imports as a share of GDP (X + M) but even as it increased trade remained roughly balanced (X – M). The era of corporate globalization (1980 – 2000) saw a continuing expansion in trade as a share of GDP, but now the goods trade deficit increased as a share of GDP. The era of China-centric globalization (2000 – present) saw a further small increase in trade as a share of GDP, a continuing large goods trade deficit as a share of GDP, and a large increase in China's share of U.S. trade.[1] Goods exports to China

Table 1. The emergence of China-centric globalization

(X = goods exports, M = goods imports, GDP = gross domestic product).

	[X+M]/GDP	[X-M]/GDP	China X/X	China M/M	China[X-M]/[X-M]
1960	6.7%	0.1%			
1980	17.0%	-0.1%	1.8%	0.1%	N.A.
2000	20.2%	-4.5%	2.0%	8.1%	18.8%
2010	22.0%	-4.4%	7.1%	18.8%	42.2%

Source: Economic Report of the President, Congrssional Research Service, Census Bureau and author's calculations.

increased as a share of total exports; imports from China increased as a share of total imports; and the trade deficit with China increased as a share of the total trade deficit.

Though globalization relies on the long-standing process of international trade, it is also fundamentally different. The earlier free trade regime was based on exchange of goods and services in a world in which production was relatively immobile. Globalization involves the creation of a system in which production is highly mobile and readily shifted between countries. Trade is an essential part of globalization because goods produced in one country must still be able to pass to another. However, the essence of the new system is flexible global production networks in which production patterns can be rapidly rearranged. That is possible because of the international mobility of the means of production, including capital, technology and organizational know-how.

The shift from free trade to globalization to China-centric globalization has been U.S. led, and involved a gradual process over several decades. Like all transformations, change was smooth rather than discrete. Proponents of globalization continued to couch their economic arguments in terms of the benefits stemming from the global application of the principle of comparative advantage. At the geo-political level, their argument was that trade promoted freedom and helped keep the world safe from communism. However, in reality globalization represented an entirely new agenda. Whereas the earlier free trade agenda (1945 – 1980) aimed to create a global marketplace, the post-1980 globalization agenda has aimed at creating a global production zone.

The Tokyo GATT round of 1979, which involved 102 countries and which delivered major tariff concessions, marked the end of the post-World War II free trade agenda. The new globalization agenda began taking shape with the Uruguay GATT round negotiations that kicked off in 1986 and that were completed in 1994. Like previous rounds, the Uruguay round produced tariff reductions. But it also introduced new legal protections for intellectual property and foreign investors, established textile access provisions that showed how emerging market economies could be fully integrated into a unified global economy, and paved the way for creation of the World Trade Organization (WTO). These innovations created a new map for the global economy.

The 1994 North American Free Trade Agreement (NAFTA) was the second critical step in the globalization process as it fused the U.S., Canada, and Mexico into a unified production zone. For the first time, developed and developing economies were joined in a common free trade production zone, thereby establishing the template corporations wanted. This changed, among other things, the significance of exchange rates, which had previously mattered for trade but now also mattered for the location of production. Consequently, corporate attitudes to exchange rates also changed, and multinational corporations began favoring a strong dollar because it lowered the price of imported products and raised profit margins on their foreign operations – a development that has become even stronger under China-centric globalization.

The third step, marking the switch from globalization to China-centric globalization, occurred in the late 1990s. By this time, U.S. corporations saw how globalization boosted profits by lowering production costs of imported goods and putting downward pressure on U.S. wages. Accordingly, they began pushing for inclusion of China—potentially an even lower cost producer—within the system. China-centric globalization was formally inaugurated when the U.S granted permanent normal trading relations (PNTR) to China in 2000, and the process was completed with China's admission into the WTO in 2001.

Distinguishing globalization from China-centric globalization

The issue of China-centric globalization is difficult to define because it inevitably raises a broader debate about globalization. In effect, there are three positions on globalization and China. The first position is that both globalization and China-centric globalization are good, and policy needs little or no change. This position can be identified with the U.S. Chamber of Commerce and groups sponsored by large multinational corporations such as the U.S. – China Business Council and the National Foreign Trade Council.

The second position is that globalization is good but China-centric globalization has caused problems. This second position is itself divisible. At one end there is an argument that globalization should have proceeded without China's formal participation (i.e. in bodies like the WTO because China is a non-market economy and operates with rules that would inevitably cause conflict and problems). At the other end is the view, associated with the likes of the Peterson Institute for International Economics and the Brookings Institution, that globalization is good and China-centric globalization can be good too. All that is needed is for China to adjust its policies regarding the exchange rate.

A third position is that globalization is bad and China-centric globalization has profoundly worsened its effects. This third view is associated with the American labor movement and it too is divisible. On one side there is a view that though the current corporate globalization model is flawed, it is worth pursuing an alternative worker-friendly version of globalization. On the other side is the classic protectionist view that globalization and free trade are bad owing to excessive societal costs and the entire process of globalization needs to be rolled back as much as possible via the imposition of significant across-the-board tariffs.

These different positions show how easy it is for discussion of China-centric globalization to spiral into debate about the broader issues of globalization and free trade that lurk in the background. Keeping the discussion manageable therefore requires focusing on the additional concerns raised by China-centric globalization.

Manufacturing and economic security

The U.S. – China economic relationship has been marked by transfers of technology and manufacturing capacity to China, significant financial investment in China, and the emergence of a huge trade deficit that over the years has made China the largest foreign holder of U.S. government debt. These developments have raised widespread economic and national security concerns about the impact of China-centric globalization.

One principal concern has been the erosion of U.S. manufacturing owing to the trade deficit with China and the diversion of investment from the United States to China. The argument is that decline of manufacturing threatens future growth and prosperity via reduced long-run productivity growth. That is because manufacturing has historically enjoyed faster productivity growth than other sectors of the economy and may also have positive external effects on productivity growth in those other sectors.[2] Furthermore, a reduced manufacturing sector undermines the capacity to export and increases reliance on imports, thereby risking creation of a structural balance of payments deficit that can constrain growth and employment. Lastly, loss of manufacturing jobs can have negative short-run growth effects by undermining aggregate demand at a time of demand shortage. This is because manufacturing jobs have historically paid higher wages, manufacturing has a large job multiplier via its demand for inputs and services, and manufacturing has traditionally had a higher rate of unionization which exerts a positive impact on the overall wage structure and income distribution.

Using a disaggregated input-output methodology that calculates the number of jobs embodied in U.S. exports to and imports from China, economist Robert Scott reports that between 2001 and 2007 the U.S. – China trade deficit caused the loss or displacement of 2.3 million jobs.[3] These adverse job effects were felt in all 50 states, affected all categories of manufacturing employment, and adversely impacted displaced workers who suffered an average income loss of $8,146 per year.

Erosion of the manufacturing base also entails national security risks. That is because a shrunken manufacturing base and increased reliance on imported manufacturing goods (either final goods or intermediate inputs) can threaten the ability of the U.S. to adequately equip a modern military and fight a lengthy war. Such dependence on manufactured imports would create a potential national security risk for the U.S. regardless of the foreign country. However, it becomes especially significant given the extent of the U.S. dependence on China and given China's uncertain geopolitical relationship with the U.S.

Table 2 captures the increased U.S. dependence on imported manufactured goods. In 1980 non-petroleum goods imports were equal to 30.5 percent of U.S. manufacturing GDP. By 2000, this ratio had risen to 78 percent, and by 2007 it was 96.3 percent. Over the same period (1980 – 2007), Chinese goods imports rose from 0.6 percent of non-petroleum imports to 19.7 percent, and they rose from less than 0.2 percent of manufacturing GDP to 18.9 percent. In 2007, the peak year of the last business cycle, goods imports from China were therefore almost one-fifth of total U.S. manufacturing output.

Table 2. Trade and U.S. manufacturing GDP

(M = goods imports).

	Non-petroleum M/ manufacturing GDP	China M/ Non-petroleum M	China M/ Manufacturing GDP
1980	30.5%	0.1%	0.0%
2000	78.0%	9.1%	7.1%
2007	96.3%	19.7%	18.9%

Source: Economic Report of the President, Bureau of Economic Affairs and author's calculations.

Citing figures produced by the U.S. Business and Industry Council, Sheila Ronis reports that between 1997 and 2004 import penetration for aircraft increased from 15.2 to 24.5 percent; for aircraft engines and engine parts from 40 to 51.6 percent; for relays and industrial controls from 24.1 to 46 percent; for analytical laboratory instruments from 29.9 to 44.7 percent; for metal-cutting machine tools from 58.6 to 72 percent; for turbine and turbine generator from 25.4 to 49.4 percent; and for speed changes, high speed drives and gears from 38.5 to 63.1 percent.[4] These declines in U.S. manufacturing capacity coincide with the implementation of the strong dollar policy in 1997 and the subsequent onset of China-centric globalization.

This loss of manufacturing capacity has both static and dynamic security implications. At the static level, it potentially undermines the U.S. ability to provision the military and provide security. At the dynamic level, it threatens the future strength of the U.S economy because manufacturing is a critical source of productivity growth, and a smaller manufacturing base implies smaller future gains from productivity improvements. This dynamic threat promises to increase as China moves up the manufacturing value chain and displaces increasingly advanced sectors of the U.S. economy.

A second concern is off-shoring of R&D facilities to China and other emerging economies. Off-shoring of R& D is worrying because it stands to reduce the flow of future innovations, thereby diminishing future economic strength and prosperity. It also adds to China's own economic strength.[5] A survey by China's Ministry of Commerce reported that by June 2004 multinationals including GE, Intel and Microsoft had set up over 600 R&D centers in China involving expenditures of more than $4 billion.[6] Between 1992 and 2004, China more than doubled its expenditures on R&D from 0.6 percent of GDP to 1.3 percent, and almost all of this expenditure has been funded by foreign investment.[7] Moreover, much of this R&D has been focused in the high-tech industry, and it is attracted by strategically designed Chinese policy.[8]

The growth of China's manufacturing capacity has clearly strengthened its ability to support a large fully equipped modern military. Much modern manufacturing technology is either directly dual-use or lends itself to a learning process that enhances indirectly a country's military potential. In this sense, foreign direct investment in non-military manufacturing facilities can potentially undermine national security.

Financial security

Trade deficits must be financed, and the financing of the U.S. trade deficit with China has contributed to the build-up of large Chinese holdings of U.S. financial assets. These large Chinese financial holdings raise concerns about a financial security threat. While this threat should not be overstated, China's holdings of U.S. debt still provides reason for concern, especially as it would give China another point of leverage during a geo-political crisis or showdown with the U.S.

In February 2011 Mainland China and Hong Kong held $1,278.7 billion of U.S. Treasury securities, representing 41 percent of all foreign official holdings of such securities. In 2011, federal debt held by the public (i.e. excluding holdings of Social Security, the Federal Reserve, etc.) was estimated to be $10,857 billion, so that China and Hong Kong own 11.8 percent of total. These holdings pose both an economic cost and a financial security threat.

With regard to cost, the debt entails interest payments to China that are a form of tax on the U.S. economy. To the extent that these payments go unspent, the drain of income puts deflationary pressure on the U.S. and global economy. To the extent they are spent, that is good for demand and stimulates production, but it also means that U.S. output in effect goes to China rather than to increasing U.S. economic well being. As with household debt, there is a real cost to becoming an international debtor as a country must pay over part of its income as interest.

With regard to financial security, China's financial holdings give it significant power and leverage over U.S. financial markets. China's Treasury holdings were slightly larger than the Federal Reserve's holdings, which stood at $1,213 billion as of February 23, 2011. At that date, the total value of Federal Reserve assets was $2,537 billion, making China's holdings equal to approximately 50 percent of the Federal Reserve's balance sheet. That means China can affect U.S. financial conditions just as the Federal Reserve can.

From a financial security perspective, the danger is that China might disrupt U.S. financial markets by engaging in strategic selling of its holdings, which in turn could injure the U.S. economy. This renders the U.S. economy potentially hostage to Chinese policymakers and for that reason constitutes a national security risk.

However, this threat can easily be over-stated. First, China is constrained from undertaking such actions, because it would incur losses on its asset holdings if it sold them to drive down bond prices and drive up U.S. interest rates. China would also suffer economic damage if the U.S. economy were hit because of China's dependence on exports. As Keynes observed: "If I owe you a pound, I have a problem, but if I owe you a million the problem is yours."

Second, the U.S. has significant defenses against financial aggression. U.S. debts to China are denominated in dollars and represent a promise by the Treasury to pay dollars at date of maturity. Consequently, the Federal Reserve can always create money and buy any debt that China chooses to sell. Such action by the Federal Reserve would have implications for inflation, the exchange rate and global financial markets, but it would blunt any immediate damage caused by Chinese selling. The recent financial crisis and interventions of the Federal Reserve have shown the power of the Fed, and that power can also be used to check hostile financial actions by China.

Lastly, the U.S. Treasury has emergency powers to freeze Chinese holdings in the event they are being used to undermine national security. Such freezes have been invoked before in dealings with dictatorships in Iran, Iraq and Libya. And they could be used again in case of a crisis with China.

For all these reasons, the financial threat is not as serious as it is sometimes portrayed. But it is still real and gives China power to cause costly financial disruption. History also provides a lesson about the power of finance. In 1956 the Eisenhower administration used its creditor powers to pressure Britain to withdraw from the Suez Canal and hand it over to Egypt. The U.S. is in danger of giving China that power today.

Geo-political security

Whereas much attention has been directed to traditional national security concerns raised by the erosion of the U.S. manufacturing base, the loss of U.S. R&D facilities, and the rise of China's financial standing, less attention has been paid to the geo-political implications of the increase in China's manufacturing capacity. The reality is that China's rise as the factory for the world and its growing financial worth are of enormous geo-political significance and affect every region of the globe – East Asia, Africa, Australia, Latin America, and Europe.

The Cold War era (1945 – 1989) was characterized by almost complete separation of East and West, as symbolized by the metaphor of the 'iron curtain." In that era, military and ideological power was critical for geo-political standing. In the post-Cold War era (1989 – present), countries are increasingly engaged in commercial rivalries that pit them in a clash of geo-economic interests. In this new era, geo-political standing depends on geo-economic power, and geo-economic power depends on the ability to develop commercial alliances.

The growth of China's manufacturing capacity and financial strength increases China's geo-economic power in ways that are immediate and significant, and in ways that undermine U.S. geo-political power. First, China's newfound manufacturing capacity gives it commercial power that binds other countries' economic interests to China. Second, China-centric globalization gives China power by reshaping the global organization of manufacturing and placing China at the center of the global supply chain. Third, China's increased financial wealth enables it to buy support and create financial dependency.

These structural changes are further leveraged by China's political system, which enables it to use state control over companies to leverage its commercial power. For instance, in dealings with developing countries, Chinese state-owned companies can pursue projects that are not bound by standard commercial constraints (e.g. profitability) or public disclosure requirements. In dealings with advanced countries, it can pressure companies to agree to “offsets” involving the transfer of technology and production.

Power is intrinsically relative. Other things being equal, an increase in the strength of a rival diminishes one’s own power. That holds for military strength, and it also holds for economic strength in a world of geo-economic rivalry.

China’s geo-political financial challenge

In addition to posing a financial security threat, China’s accumulation of U.S. financial assets poses a financial challenge to U.S. geo-political power. This is because accumulation of financial wealth gives China global influence. This increased influence is visible in China’s claims to an increased say in multilateral institutions such as the World Bank and International Monetary Fund. In the contest to replace former IMF managing director Dominique Strauss-Kahn, Zhou Xiaochuan, China’s current central bank governor, was openly mooted as a candidate despite the fact China is undemocratic, its export-led growth policies are damaging to many other emerging market economies, and it has repeatedly refused to play by the rules of the game regarding exchange rates and has ignored IMF suggestions that it revalue its currency.

China’s new financial power is also evident in its ability to offer foreign aid and extend large scale commercial credit to finance trade and development. This financial power has been evident is China’s recent support for Greece, Portugal and Spain whose bonds it has purchased. That has won China plaudits in these countries for helping them finance their fiscal shortfall, when in reality the actions can be viewed as part of China’s policy of global exchange rate manipulation (about which more below).

Going forward, the financial wealth China has acquired via its trade surplus with the U.S. may now create a wall of money that can shape global economic relations. A China move to redeploy these funds out of U.S. Treasury bonds would risk doing the U.S. double harm. First, the prospect of asset redeployment would be highly seductive to other countries so that the world may become overly attuned to Chinese concerns, to the point of being willing to ignore and appease China’s actions. Second, asset sales would put additional pressures on U.S. financial markets and could complicate U.S. domestic economic policy management.

The global supply chain and East Asia

For over a century, East Asia and South-East Asia have been viewed by U.S. foreign policymakers as strategically important. Both regions have been fundamentally affected by China-centric globalization and the rise of China as a manufacturing power. That impact has operated via changes in the structure of global supply chain, which is now increasingly centered around Chinese manufacturing. And for the U.S., these changes have created a new vulnerable dependency on a global supply chain that it no longer controls.

Foreign outsourcing inevitably raises national security concerns because it shifts parts of the supply chain outside a country's borders, which is intrinsically more dangerous. The threat level then depends on (i) the vulnerability of the foreign supply chain (often proxied by distance), (ii) the extent of foreign supplier diversification (proxied by the number of supplier countries), and (iii) the extent of quantitative reliance on foreign suppliers (proxied by imports as a share of manufacturing output). Greater distance, fewer supplier countries, and greater quantitative reliance all increase the potential national security threat.

China-centric globalization has increased this threat by making the U.S. global supply chain more vulnerable to interruption. This threat to the U.S. global supply chain is illustrated in Figures 2 and 3. Figure 2 contains a stylized illustration of the 1980s global supply chain which had the U.S. supplied by many East Asian countries (Japan, South Korea, etc.). This exposed the U.S. to dangers of distance, but the supply chain was relatively well diversified and the level of quantitative dependence was also low. China-centric globalization has restructured the supply chain, placing China at the center in a role as assembler. Figure 3 provides a stylized representation of this new pattern. China is now positioned as a product assembler, receiving inputs from East Asian suppliers that are assembled and then shipped to the U.S. market. This middleman position gives China increased leverage since it controls a greater share of supplies going to the U.S. at a time when the absolute level of U.S. reliance on foreign supplies has increased. Thus, in 2006, total U.S. imports from Asia – Australia Pacific rim countries were $618.5 billion, of which China supplied 46.5 percent ($287.8 billion).

Figure 2. Stylized representation of the 1980s global supply chain.

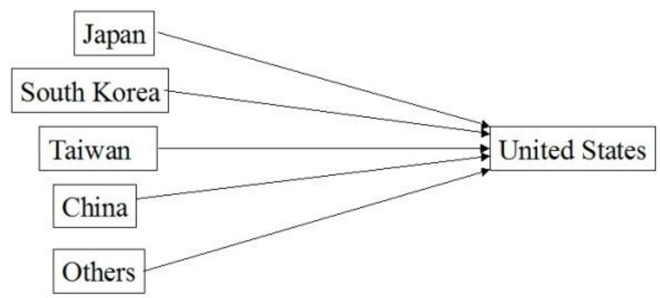
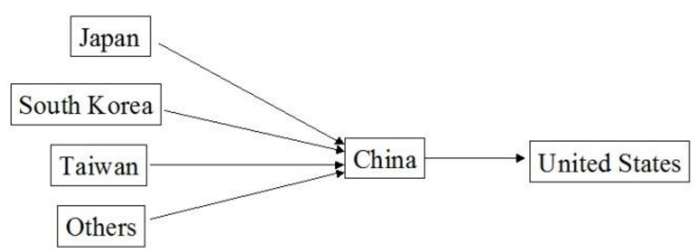


Figure 3. Stylized representation of the 2000's China-centric global supply chain.



The new pattern of global sourcing via China is also visible in the pattern of East Asian intra-regional trade. Table 3 shows how East Asian intra-regional exports rose from 44.1 percent of all exports in the period 1990-94 to 49 percent of all exports in the period 2000-04. During this period, East Asian exports to China rose from 6.4 percent to 11.1 percent, so that increased East Asian country exports to China accounted for almost the entire deepening of East Asian intra-regional trade. Meanwhile, China's exports to the East Asia region fell as a share of Chinese exports from 60.5 percent to 45.3 percent, reflecting the hub model in which China's relies on North American and Western European markets to make final sales.

Table 3. Changing patterns of intra-regional East Asian trade: percent of total exports going to East Asia and China.

EXPORTER	East Asia 1990-94	East Asia 2000-04	China 1990-94	China 1990-94
East Asia	44.1	49.0	6.4	11.1
China	60.5	45.3	n.a.	n.a.

Source: M. Haddad, "Trade Integration in East Asia: The Role of China and Production Networks," World Bank Policy Research Working Paper 4160, March 2007.

Table 4 breaks down East Asian intra-regional trade by country, and every country recorded an increase in the share of their exports going to China. In many instances (Hong Kong, Indonesia, S. Korea, Malaysia), increased exports to China accounted for all of the country's increase in East Asian export share. This reveals the extent to which East Asian countries are funneling exports through China.

Table 4. Changing country composition of intra-regional East Asian trade: percent of total exports going to East Asia and China.

Exporter	East Asia 1990-94	East Asia 2000-04	China 1990-94	China 2000-04
Hong Kong	47.0	55.5	29.9	39.3
Indonesia	62.0	56.9	3.6	5.4
Japan	34.6	43.1	3.7	10.0
S.Korea	40.8	46.6	4.2	15.6
Malaysia	54.7	54.2	2.5	5.3
Philippines	36.1	53.7	1.2	4.2
Singapore	48.2	56.4	2.0	6.1
Taiwan	42.7	55.2	0.0	10.3
Thailand	41.7	48.3	1.5	5.3
Vietnam	--	49.0	--	9.6

Source: M.Hadad, "Trade Integration in East Asia: The Role of China and Production Networks," World Bank Policy Research Working Paper 4160, March 2007.

This pattern of China-centric globalization has two negative effects for the United States. First, it reduces source diversity in the U.S. global supply chain, thereby making the U.S. more dependent on China and more vulnerable to interruptions of supply by China. Second, it makes countries in East Asia more dependent on China as a market for their exports. This latter effect has been almost entirely over-looked. Making the countries of East and Southeast Asia more economically dependent on China increases China's geo-political power. Given that Southeast Asia is an important region of geo-political competition between the U.S. and China, this economic reorientation weakens the U.S. position in the region.

In this regard, it is noteworthy that many ASEAN countries now view China as the region's engine of economic growth, for which China gets significant diplomatic credit. There is a certain logic to this ASEAN view even if it is mistaken. On the surface, it looks as if China has been the source of growth in East Asian intra-regional trade, as shown in Table 4. However, this growth is a form of "derived" growth that ultimately depends on China's ability to export to North American and Western

European markets. This is evident in Table 3, which shows China's export share to East Asia falling, reflecting China's growing reliance on markets outside the region.

The net result is China gets the regional political credit for East Asia's economic growth, when the driver of much of the growth has been markets outside the region (including the U.S. market). These markets represent the final market but their visibility is obscured locally because the China-centric globalization supply chain is intermediated through China. Moreover, even if East Asian countries see through this pattern, they have limited options as not participating in the new China-centric supply chain would impose immediate large economic costs. Consequently, long-term strategic interests are sacrificed for short-term economic concerns.

All too often China's economic power is discounted on grounds that China's role in the global supply chain is one of an assembler that adds little value-added in production. Such a perspective misses the strategic national security implications of that assembler role. Compounding the oversight is the fact that China's newly acquired economic role has been made possible by foreign direct investment (FDI), which has transferred manufacturing capacity and technological know-how to China. The significance of FDI is evident in Table 5, which shows foreign multinational corporations account for over 50 percent of China's exports, and foreign multinational corporations and joint-ventures account for over 75 percent of China's exports.[9] Although not the largest investors, U.S. corporations have nevertheless been significant contributors to FDI in China.[10]

Table 5. Decomposition by firm ownership structure of Chinese exports and imports in 2005.

Source:Manova and Zhang, 2008

	All firms	State-owned	Private domestic	Joint ventures	Foreign-owned
Exports	100%	10.3	13.1	26.3	50.4
Imports	100%	21.7	7.1	24.1	47.2

China's resource diplomacy in Africa, Latin America and Australia[11]

China's rise as a manufacturing powerhouse has fueled an enormous increase in its demand for natural resources of every kind. This increase has in turn triggered a new wave of resource-oriented diplomacy, aimed at securing long-term resource supplies. This resource diplomacy is significantly reshaping China's relations with Africa, Latin America and Australia. That inevitably affects these regions' relations with the U.S., and it does so in worrying ways.

The new resource diplomacy is the direct consequence of China-centric globalization, which explains both why China needs the resources and how it is able to secure them. China's need for resources stems from its manufacturing advance, and these advances in turn give China the wherewithal in the form of manufacturing exports and foreign exchange holdings to invest in resource acquisition and to buy political influence in resource rich countries.

For the U.S., China's resource diplomacy entails significant economic costs. China's competition for resources has driven up the price of virtually ever resource at a cost to U.S. producers and consumers. As importantly, China's resource diplomacy also has potentially significant geo-political costs as resource rich countries form new commercial alliances with China that diminish

U.S. geo-political standing. That might be of little consequence if the new alignments were unambiguously beneficial for the countries and the global economy, but they are not. Though countries have benefited from higher commodity prices and higher commodity incomes owing to China, there are also significant downsides that harm their economic and political development.

All of these concerns are visible in Africa where China's rise has produced both positive and negative effects. With regard to the postive, China's rise has had three major economic benefits for Africa. First, China has increased demand for African commodity exports, which has contributed to higher commodity prices. Second, China's rise has triggered a surge in FDI in Africa, particularly in the commodity production sector, to which China has contributed. Third, China's rise has increased the global supply of manufactured goods that Africa imports and consumes, which has lowered the price of manufactured goods. These developments have raised Africa's national income, loosened the external financial constraint on development, and increased economic growth.

These positive effects are welcome. But, they are off-set by several negative effects that impede Africa's development and also undermine U.S. standing in the region.

First, China uses mercantilist economic development policies that compete with Africa and make it more difficult for Africa to develop its own manufacturing base. This is particularly clear for South Africa, which is Africa's most industrially developed economy and therefore competes most directly with China. China tends to crowd out African economies that seek to industrialize by dominating first-rung industries like textiles and apparel. China's development strategy employs export-led growth based on an under-valued exchange rate and wage suppression. It also actively courts FDI with these policies, and that has resulted in China sucking up a large share of global FDI in manufacturing. It is difficult enough that Chinese exports compete with African domestic production. However, the problem is exacerbated because China holds down its exchange rate while some African country exchange rates have appreciated because of the commodity price boom. Again, this is particularly true for South Africa.

Second, Africa suffers from the "natural resource curse" problem.[12] In political environments where rule of law and democracy are weak, natural resource wealth tends to trigger corruption and internal conflict as groups fight for control over the spoils. That has a devastating effect on economic development and social stability. The global commodity boom, to which China has contributed, plays into the problem of the natural resource curse. While China cannot be blamed for the natural resource curse, its political system amplifies the problem. China is not a democracy and has significant corruption problems of its own. Additionally, it takes an extremely nationalistic perspective in its dealings with the global economy. Consequently, it puts its access to resources above all other considerations, aggravating the natural resource curse problem in the process. The best example of this is Sudan, where China has disregarded the problem of genocide in Darfur and given significant economic help to the Sudanese regime in exchange for oil.

Third, China obstructs the development of human rights and labor standards. Labor standards promote economic development, making them both a means and end of development.[13] However, China resists complying with both international human rights and labor standards because of its authoritarian political system. Consequently, it also disregards human rights and labor standards in Africa, which is bad for African social, political, and economic development. An example of this is China's continued investment in the Zambian copper mines in spite of reports of major labor abuses over the years.[14]

China's rise as a manufacturing powerhouse is central to its new relationship with Africa, and it is also central to its ability to challenge the U.S. geopolitically in Africa. To fully understand the geo-political implications of China's increased manufacturing capacity, it is worth comparing China with the Soviet Union in the 1970s. In the 1970s the U.S. and the Soviet Union were engaged in competition in Africa. The Soviet Union's power was as provider of weaponry and provider of a global revolutionary ideology and rhetoric. However, at the economic level there was little fit between the Soviet Union and Africa.

The Soviet Union was itself a natural resource producer and had little demand for African natural resources. The Soviet Union also lacked global manufacturing prowess and the ability to supply cheap consumer and investment goods. That gave it no basis for an integrated mutually beneficial economic relationship with Africa, which imports manufactured goods and exports primary products. Consequently, when it came to economic competition, the U.S. always held the upper hand versus the Soviet Union.

Contrast this with China which, like the Soviet Union, can also supply weaponry and also it has its own particular brand of revolutionary rhetoric rooted in its experience as a third world developing communist country. Indeed, that rhetoric may play even better in Africa than did Soviet Marxist – Leninist rhetoric rooted in European industrialized country class conflict. On top of this, China has a strong economic fit with Africa. First, it needs Africa's natural resources. And second, it can satisfy Africa's need for cheap manufactured consumer goods and for assistance building infrastructure. This combination makes China a much more formidable geo-political rival than was the Soviet Union.

Moreover, China can claim another advantage in its ability to compete in Africa and other developing country regions because much of its economic activity in these regions is conducted through state-owned companies that are not bound by standard commercial constraints or public disclosure requirements. This lack of constraints has been particularly evident in Sudan, which China has courted for oil. That courtship has been pursued with disregard for the international community's concerns about the Sudanese government's complicity with genocide in Darfur.[15]

Australia and Latin America have also been affected by the same forces of China-centric globalization that have affected Africa. Australia is a resource-exporting developed country. Thus, like Africa, it has benefited from higher commodity prices. And like East Asia, Australia has been increasingly integrated into the China-centric global supply chain as a supplier of raw materials to China's industries. That is of geo-political concern to the U.S. because it locks Australia into a dependent relationship with China and makes China the middle-man.

The situation in Latin America is more complicated. Like Africa and Australia, many Latin American countries are also resource exporters and have therefore benefitted from higher commodity prices. Unlike Australia, however, Latin American countries are developing economies with large populations. That means they have suffered from China-centric globalization in some of the same ways that Africa has because China is an industrial rival.[16]

First, China's under-valued exchange rate has made Latin American manufacturing less competitive vis-à-vis China. That has been compounded by the fact that high commodity prices have created trade surpluses that have contributed to "Dutch disease" exchange rate appreciation, particularly in Brazil. This has had particularly negative consequences for Latin American economies because China and Latin America compete in the same manufacturing product space.

Second, China's policies of an under-valued exchange rate, wage suppression and investment subsidies have also siphoned off FDI that might have gone to Latin America and Central America. This is particularly relevant to Mexico, which has seen its hopes for NAFTA-led development increasingly undermined by China-centric globalization.

Third, China's low wages, lack of labor standards and policies of wage suppression strike at the heart of domestic demand-led development, which is essentially to Latin America's economic future.[17] That is because such policies obstruct the development of a middle class and improvement of income distribution. China's low wages are therefore a double blow to Latin America: they attract jobs away from the region, and they also undermine domestic demand by damping wage growth in the region.

For the U.S. the impact of China-centric globalization on Latin America creates two problems. First, it diminishes U.S. influence by re-orienting Latin America toward China, with Latin America taking on the role of supplying commodities in exchange for manufactured goods. Second, to the extent that China siphons investment and jobs away from Latin America and Central America, this potentially destabilizes the region. It also undermines important markets for U.S. exports and fosters illegal immigration into the U.S. that contributes to domestic political tensions.

Finally, China's growing influence in Latin America raises some political concerns for the future of the region. Latin America has a fragile history of democracy and countries have had repeated encounters with dictatorship and political suppression. However, since the early 1980s, the region has made great strides toward strengthening and deepening its democratic foundations.[18] The open question is what will be the political consequences for democracy in Latin America if the region increasingly aligns itself with China, which is an authoritarian undemocratic country?

The Trans-Atlantic relationship and Europe

China's rise as a manufacturing and financial powerhouse also has implications for the trans-Atlantic relationship with Europe. This relationship has under-pinned peace and security via NATO; was key in establishing the United Nations system; and shaped global economic governance via the IMF, the World Bank, the OECD, the GATT that became the WTO, and the G-7 governance structure that has now evolved into the G-20. The trans-Atlantic relationship has provided the bedrock of the post-World War II international order, yet it now risks being undermined by China-centric globalization that re-orients U.S. private business interests to China while triangulating the U.S. – European official relationship. Once again these developments are due to changed patterns of trade and commerce caused by the relocation of manufacturing to China.

This decline in the trans-Atlantic relationship is visible in U.S. – Europe trade statistics. As shown in Table 6, between 1980 and 2010 the share of U.S. trade with Europe fell from 25.2 percent of total trade to 21 percent.

Table 6. U.S. – European trade, 1980 – 2010.

	Exports to Europe/X	**Imports from Europe/M**	**Exports to + Imports from Europe/[X + M]**
1980	32.0%	19.2%	25.2%
2000	24.0	21.2	22.3
2010	22.5	20.0	21.0

Source: Bureau of Economic Affairs plus author's calculations.

Europe and the U.S. still have massive engagement with each other via trade and accumulated FDI. However, at the margin they now have diverging interests vis-à-vis economic relations with China. Analytically, the U.S. and Europe are caught in a prisoner's dilemma with regard to China. The logic of the prisoner's dilemma is illustrated in Figure 4. Two companies are placed in competition with each other by China. If one competes and the other does not, the pay-off is plus 10 for the competitor and minus 10 for the other. If both compete, they each get minus 5. If neither competes, they both get plus 5. The best thing for them is to co-operate and not compete. However, each believes it can win by going alone, so they both compete and end up with minus 5.

Figure 4. The prisoner's dilemma.

		Company B	
		Compete	Not compete
Company A	Compete	-5, -5	10, -10
	Not compete	-10, 10	5, 5

The post-war international system was set up to promote trade competition and in a liberal economic order competition can yield the best for all, but only if all countries abide by rules. The problem is that China is not a fully liberal economy. Rather, it is a non-democratic, non-market economy with significant state control, a large public sector, and a private sector subject to considerable state intervention and control. It is this state intervention that allows China to pit the U.S. and Europe against each other to China's advantage.

A recent example of such intervention was the Chinese government's pressuring of consumer goods multinationals Unilever and Procter and Gamble not to raise prices as part of an inflation control strategy.[19] Another example is the competition between Boeing and Airbus for Chinese aircraft orders, which nicely illustrates the prisoner's dilemma problem. China is able to use its state control over aircraft purchases to manipulate Boeing and Airbus into patterns of disadvantageous competition. Those patterns include forced technology transfer, shifting manufacturing and assembly to China, and using Chinese parts suppliers. This benefits China but worsens the problems for U.S. manufacturing and economic security discussed earlier, causing loss of jobs, loss of investment and loss of future productivity growth. It also transforms Boeing and Airbus from being national champions identified with the well-being of their respective national economies into international corporations without loyalty to the national economy. Lastly, it threatens the future profitability of Boeing and Airbus by creating a future competitive rival. Yet despite this, Boeing and Airbus must go along because of the structure of the prisoner's dilemma. To lose out on the China market is to lose scale and presence in a way that would fundamentally disadvantage one against the other.

The Boeing – Airbus example concretely illustrates a generic structural problem created by China-centric globalization. Given China's political structure and non-market status, it can play the U.S., Europe and Japan against each other in ways that are disadvantageous to all except China. Each country has an incentive to undercut the others to win China market share, not just via normal price competition, but by submitting to forced transfers of technology and manufacturing. This structural problem afflicts the entirety of manufacturing trade and commerce with China. As long as the U.S. and Europe are unable or unwilling to co-ordinate their policy actions, they are both vulnerable to commercial and policy triangulation by China.

This structural prisoner's dilemma problem is amplified by beliefs that China is the "dream" market. A decade ago American CEOs were seduced by this vision. Now, German businessmen may be falling for the same vision, and the pressure to believe is increased by the rapid growth of German exports to China which may surpass exports to the U.S. by the middle of the decade.

Finally, China is also using its newly acquired financial power to shape Chinese relations with Europe. In particular, China is using its accumulated dollar reserves to support the euro against the dollar by buying European debt. In countries like Greece and Spain this has been welcomed on grounds that China is helping them deal with their financial crises. The reality is that China is taking its exchange rate manipulation global. Europe is China's biggest export market. Consequently, China does not want the euro to depreciate against the dollar as that would make Chinese products uncompetitive in Europe because the renminbi is tied to the dollar.

Trouble ahead

The combination of threats to manufacturing and economic security, financial security, and geo-political security speak to the troubling nature of China-centric globalization. On top of that, there are now significant immediate dangers to the U.S. and global economies at a time when both are fragile and beset by tendencies to stagnation in the wake of the financial crisis of 2008 and the Great Recession.

The threat to U.S. recovery

China-centric globalization is deeply problematic for the U.S. from both an economic and geo-political standpoint. Since the problems are structural they will not go away and promise only to get worse. One problem that has already appeared concerns the U.S. economy's recovery from the Great Recession. The U.S. economy is still recovering from the deepest economic downturn since the Great Depression and is afflicted by a chronic shortage of aggregate demand in the wake of the housing bust. Rising imports subtract from aggregate demand growth and lower economic growth. After falling sharply in 2008, goods imports have been on the rise again and imports from China have been rising faster and have become a greater share of total non-petroleum imports. These features are captured in Tables 7 and 8. Table 7 shows how imports have negatively affected GDP growth since the recession ended in June 2009. Table 8 shows how goods imports from China have risen as a share of total non-petroleum imports.

China's reliance on exports to the U.S. has hindered U.S. economic recovery. It is also contrary to the role China should be playing to promote global economic recovery. Both as a large contributor to the problem of global imbalances and as a large surplus economy, China should be pursuing policies that add to global demand and facilitate global rebalancing. Instead, China has remained wedded to its undervalued exchange rate and export-led growth strategies, and as part of its post-crisis growth program it has even introduced "Buy China" policies favoring Chinese companies.[20]

Table 7. The negative impact of rising imports on U.S. GDP growth.

	2009. III	2009. IV	2010. I	2010. I1	2010. III	2010. IV
Contribution of goods imports to GDP growth	-2.64%	-0.68%	-1.41%	-4.46%	-2.16%	2.10%

Source: Bureau of Economic Analysis

The threat to global growth and development

Not only does China-centric globalization pose a threat to economic recovery, it also poses a threat to global growth and development. The key problem is China's export-led growth policy centered on an under-valued exchange rate pegged to the dollar. Export-led growth has been the principal avenue of development over the past 25 years for developing economies, but that strategy now appears exhausted largely because of the rise of China.[21] China's adoption of the strategy means China now occupies the bottom rung of the ladder of industrialization, leaving no room for other countries. China has too large a labor force, too low wages, and too many advantages in terms of the attractiveness of having access to its potentially massive domestic market. Consequently, other countries cannot out-compete China on cost; cannot develop manufacturing specialties of their own; and cannot attract sufficient FDI, which is diverted to China.

Table 8. China's rising share of non-petroleum goods imports.

	2009. III	2009. IV	2010. I	2010. II	2010. III	2010. IV
Non-petroleum imports ($b)	$314.6	331.7	342.3	367.7	379.1	376.3
China imports ($b)	$79.4	83.6	72.9	85.8	103.6	100.6
China share (%)	25.2%	25.2	21.3	23.3	27.3	26.7

Source: U.S. Census Bureau plus author's calculations.

Additionally, export-led growth needs a buyer, and the U.S. and Europe can no longer perform that role, in part because they are coping with the legacy of a decade of unbalanced trade with China. The U.S. is afflicted with high levels of private indebtedness and an atrophied income-generation process, which is in part caused by China-centric globalization. Europe is afflicted by high levels of public indebtedness, and it too is riven by worsened income inequality.

Along with unfairly pushing China's export-led growth model, China's dollar peg is also causing indirect problems for many developing countries, including Brazil and South Africa. That is because the commodity boom has contributed to exchange rate appreciation in these countries. Moreover, their currencies have further appreciated because of the Federal Reserve's quantitative easing policy that has pushed U.S. interest rates to near-zero. This has caused financial capital to exit the U.S. and flow to higher interest rate countries like Brazil and South Africa, causing their exchange rates to appreciate. The U.S. has a trade deficit and is suffering from recession so that low interest rates and exchange rate depreciation are appropriate. However, the wrong currencies are appreciating because of China's fixed dollar peg, which blocks renminbi appreciation. That threatens to destabilize the global economy.

Finally, as noted earlier in the discussion of the effects of China-centric globalization on Africa and Latin America, China's opposition to global labor and environmental standards adversely affects the possibility for equitable and sustainable global development. It does so by promoting a "race to the bottom" whereby countries try to gain international competitiveness by lowering standards in an attempt to reduce costs and become more attractive to FDI. China also undermines democratic development owing to its willingness to disregard concerns about democracy. This has been most evident in China's attempts to secure natural resource supplies within Africa.

The push for a flexible renminbi exposes the U.S. to a China bust

The U.S. economy has already been injured by China's under-valued pegged exchange rate. For almost 10 years, the U.S. Treasury Department has shied away from naming China a currency manipulator despite overwhelming evidence in the form of Chinese accumulation of U.S. Treasury bonds, the failure of the renminbi to appreciate significantly despite massive trade surpluses and capital inflows; and the pattern of renminbi exchange rate fluctuation. Now, U.S. policymakers are encouraging China to loosen its capital controls and adopt a flexible exchange rate.[22] This is a disastrous policy recommendation, which if implemented could expose the U.S. to a China bust and further exchange rate inflicted harm.

There is an old saying that when one is in a hole, stop digging. Yet, U.S policymakers show no indications of understanding the long-standing policy flaws that have shaped China-centric globalization. Misunderstanding about exchange rates and their impact on production, investment and trade have been a central element of the problem.

Economic theory maintains that patterns of trade, production and investment are determined by comparative advantage, which in turn is determined by the relative productive efficiency of economies. Productive efficiency is unaffected by monetary factors, and therefore trade, investment and production should not be affected by the exchange rate which is a monetary variable. Economists claim that attempts to manipulate the exchange rate downward will be fully offset by higher prices. This is core orthodox economic doctrine, and it explains why policymakers have excluded exchange rates from trade agreements.

China's ability to manipulate its exchange rate to gain competitive advantage has shown the fallacy of this doctrine, and China's under-valued exchange rate has been a critical factor in explaining the trade deficit and shift of U.S. manufacturing capacity to China. Confronted by this, U.S. policy makers are now pushing China to loosen its capital controls and float the renminbi. China is going along with this and has already introduced several measures to increase the international standing of the renminbi by allowing the issuance of renminbi bonds, encouraging the use of renminbi in trade, and permitting Chinese corporations to retain external foreign currency denominated profits. The renminbi nominal exchange rate peg has also been allowed to slowly appreciate against the dollar.

U.S. policymakers, such as Federal Reserve Chairman Ben Bernanke and Treasury Secretary Timothy Geithner, have endorsed this new policy direction while also criticizing it for being too slow. This endorsement represents the other side of the economics professions' belief—which is that financial markets determine prices that establish patterns of trade and investment consistent with full employment and balanced trade. Just as the profession has been dramatically wrong on trade and under-valued exchange rates, so too it is wrong about flexible exchange rates and open capital markets.

The reality is that a shift from "fixed exchange rates plus strict capital controls" to "flexible exchange rates plus capital mobility" will be tantamount to jumping from the frying pan into the fire. The precedent is Japan in the early 1980s. At that time, Japan was running large trade surpluses, had an under-valued exchange rate, and had significant capital account restrictions. Under pressure from the U.S. Treasury, Japan lifted its capital account controls in December 1980 (*The Foreign Exchange and capital Control Law*, 1980), yet over the next two years the yen depreciated by 20 percent. The reason is Japanese portfolios were internationally undiversified so that removal of capital controls contributed to a depreciation of the yen. Outflows from portfolio diversification by residents dominated non-resident inflows.

There is a grave risk this pattern could repeat itself with China. Chinese citizens have accumulated significant financial wealth, which is internationally undiversified. That portfolio structure alone would give Chinese citizens reason to sell renminbi. However, on top of that, there are strong political reasons for Chinese citizens to hold wealth outside China to insure against political dangers. Together, these factors could cause significant renminbi depreciation in the event of implementation of a flexible exchange rate – with an open capital account. That would expose the U.S. to further economic damage. Moreover, it would also place the U.S. in the politically difficult position of complaining about what it had asked for.

On top of the portfolio risk, there is the possibility that China could have its own internal economic bust. Many commentators have speculated on this possibility for a number of reasons, including a land and house price bubble that may have developed because of excessively easy credit and fears of future inflation in China; excessive fixed investment that has seen China devote 50 percent of its GDP to fixed asset accumulation; and a banking crisis due to accumulated bad loans made to state-owned enterprises and local governments. In the event of a Chinese economic crash, the dollar would almost certainly appreciate against the renminbi if exchange rates are flexible and Chinese financial flows are unrestricted.

The solution is neither flexible exchange rates nor free capital mobility. Instead, China should maintain its system of a pegged exchange rate with capital controls, but the peg should be set to ensure approximately balanced trade. However, U.S. policymakers have an ideologically based commitment to flexible exchange rates and capital mobility. As a result, they are now pushing another flawed arrangement that is likely to blow up in the future with grave consequences for the U.S. economy.

Rolling the dice with history

It has now become clear that China-centric globalization has done significant economic damage and poses significant economic and geo-political dangers. For U.S. blue collar workers, it has inflicted grave injury through its impact on manufacturing employment. For the U.S. economy as a whole, it has also inflicted damage by contributing to the financial crisis and the Great Recession, which has in turn boomeranged to cause damage in the global economy.[23]

The failure of Europe and the U.S. to co-operate and address China, combined with the failure to develop sensible tough rules for the global economy, means China-centric globalization puts China in the driver's seat. From the standpoint of U.S. geo-political power, the critical difference from the Cold War is the Soviet Union failed to build a manufacturing base that could supply the world, sustain trade surpluses and enable it to accumulate massive foreign exchange reserves. China-centric globalization, which is significantly the product of U.S. policymakers and U.S. corporations, enables China to accomplish exactly this. In doing so, it makes China a potent geo-political force in the post-Cold War era in which geo-economics is the main dimension of rivalry.

As noted earlier, China-centric globalization constitutes a momentous process that is causing changes of historical proportions. This process has developed rapidly with little public consideration of its implications and consequences. It is well past time for a full discussion of the dangers inherent in a process that as this paper argues is transforming the world's geopolitical landscape in such worrying ways.

Endnotes

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MAIN OFFICE
1899 L Street, NW
Suite 400
Washington, DC 20036
Phone 202 986 2700
Fax 202 986 3696

CALIFORNIA OFFICE
921 11th Street
Suite 901
Sacramento, CA 95814
Phone 916 448 5189

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